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January 24, 2018

VIA EMAIL: John.Larsen@alaska.gov

John Larsen, Audit Master
Alaska Department of Revenue
550 W. 7th Ave., Suite 500
Anchorage, AK 99501

Re: Calculation of prevailing value of oil sold in the state

Dear Mr. Larsen:

Caelus Energy Alaska, LLC (Caelus) submits this correspondence in response to DOR's invitation to comment on the application and calculation of prevailing value for oil sold in the state in 15 AAC 55.171.

The concept of prevailing value is market-driven and the marketplace for Alaska North Slope crude is the West Coast of the United States. The structure of the regulation governing prevailing value for oil, 15 AAC 55.171, tracks that concept and should be interpreted accordingly. The baseline for the calculation is 15 AAC 55.171(a), which requires the use of the average ANS West Coast spot price. For ANS sold in the state at tidewater or to coastal refineries, the prevailing value is ANS West Coast spot price less a location differential calculated based on average marine transportation costs.[1] In turn, for ANS sold at the Trans Alaska Pipeline System (TAPS) pump station one, or the entrance to another regulated pipeline, the calculation again starts with ANS West Coast spot price, which is then reduced by the marine transportation location differential and again reduced by the carrier ownership-weighted average of all *applicable* publicly filed pipeline tariffs and quality bank differentials.[2] In other words, the calculation of prevailing value consistently starts with ANS West Coast spot prices.

In regard to ANS sold at TAPS pump station one or the entrance to another regulated pipeline, 15 AAC 55.171(g) provides that "[i]f a carrier has more than one *applicable* publicly filed pipeline tariff, the lowest tariff filed by that carrier must be used in calculating the carrier-ownership weighted average."[3] As discussed above, prevailing value is a market-driven concept and the market is the West Coast, which is clearly contemplated by the regulation. Accordingly, the *applicable* tariff is the interstate tariff set by the Federal Energy Regulatory Commission (FERC), rather than the intrastate tariff set by the Regulatory Commission of Alaska (RCA)—a sensible result given that virtually all ANS crude enters interstate commerce.

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[1] 15 AAC 55.171(f).
[2] 15 AAC 55.171(g)
[3] Emphasis added.

However, over the last year DOR appears to have changed its interpretation of this regulation to allow it to choose the lower of the FERC or RCA tariff in applying 15 AAC 55.171(g). Not only does this ignore the reality that virtually all ANS enters interstate commerce, it ignores the principle that prevailing value is market-driven, and it completely disregards the structure of 15 AAC 55.171, which consistently starts with ANS West Coast spot prices. The absurd result of DOR's change in interpretation is that now all components of the prevailing value calculation are based on interstate commerce except for pipeline transportation—at least when the RCA tariff is lower than the FERC tariff. And to take an even greater step from reality, DOR has applied the RCA tariff to *all* ANS crude for which prevailing value is calculated under 15 AAC 55.171(g) without even attempting to make an allocation between interstate and intrastate sales.

It is inequitable and unreasonable to completely de-link the calculation of prevailing value from reality and the structure of the regulation. Producers that sell at TAPS pump station one would not be punished in this manner if the sales took place at the Valdez Marine Terminal.

Caelus requests that DOR return to its earlier interpretation and consistently use FERC tariffs in the prevailing value calculation. A return to the prior policy would be equitable as well as sound and reasonable policy, particularly given the structure of 15 AAC 55.171 and the actual market for ANS crude.

Respectfully,

Marc A. Byerly
Vice President and Controller

STATE OF ALASKA
DEPARTMENT OF REVENUE
TAX DIVISION

In the Matter of the Application and	)
Calculation of the Prevailing Value for	)
Oil Sold in the State in 15 AAC 55.171	)
	)

COMMENTS OF ANADARKO PETROLEUM CORPORATION

Anadarko Petroleum Corporation ("Anadarko"), through its counsel, Brena, Bell & Clarkson, P.C., pursuant to the State of Alaska ("State" or "Alaska"), Department of Revenue's Request for Public Comments on the application and calculation of the prevailing value for oil sold in the state in 15 AAC 55.171, dated December 21, 2017, hereby submits its comments. Anadarko submits these comments to address a recent change in the State's interpretation of the regulations governing the calculation of the prevailing value of oil for royalty and severance tax purposes.

1. Executive Summary.

Anadarko has relied on the State's longstanding policy of using the Trans Alaska Pipeline System ("TAPS") interstate tariff rate in a netback calculation to determine the prevailing value of certain Alaska North Slope ("ANS") crude produced by Anadarko for tax purposes. Recently, the State has changed its position and has applied the intrastate tariff rate to its netback calculation for determining the prevailing value of ANS as applied to Anadarko's oil that is delivered within the state of Alaska. The State's change in position has resulted in financial and competitive harm to Anadarko.

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There are several reasons the State should continue to apply its longstanding policy of using interstate transportation rates when determining the "prevailing value" for royalty and severance taxes. First, 15 AAC 55.171 requires the prevailing value for ANS crude oil be determined based on its market value on the West Coast.[1] This regulation follows the established economic principle that the value for oil and gas is properly determined at the nearest liquid point or marketplace in which the commodity is actively traded. The State, through its statutes, regulations, ANS royalty settlement agreements, and royalty-in-kind ("RIK") contracts has long recognized this basic economic principle and requires ANS crude oil to be valued based on its value in the West Coast marketplace.

Second, when determining the prevailing value at a point-of-sale other than the West Coast, AS 43.55.011 and 15 AAC 55.171 require that transportation costs necessary to transport ANS crude oil from the point of sale to the West Coast be subtracted through a basic net-back calculation.[2] Critically, the only "applicable" transportation rate historically, legally, logically, or practically possible to use in a net-back calculation to the West Coast marketplace is the interstate transportation rate that actually links the point of sale with the West Coast. It makes

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[1] 15 AAC 55.171(f) states, "The prevailing value for ANS sold in the state at tidewater or delivered to coastal refineries in the state is the prevailing value determined in (a) of this section minus the volume-weighted average location differential between the Port of Valdez and the United States West Coast provided for under contracts for the sale of ANS delivered in the state during the previous calendar year. . . ."

[2] 15 AAC 55.171(h) states, "The prevailing value for ANS delivered to an inland refinery in the state is the prevailing value as determined in (f) of this section, minus the carrier ownership-weighted average of all applicable TAPS tariffs." As noted above, 15 AAC 55.171(f) uses the West Coast market price as the beginning point for valuing ANS, therefore, the only *applicable* tariff in a netback calculation is the interstate rate. . . .

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no sense to subtract an inapplicable "intrastate" transportation rate between the point of sale (the ANS) and the West Coast, which is "interstate" activity.

Third, the State should ensure that all North Slope producers are treated equally under the tax regime. Currently, the State is favoring affiliated producers when applying 15 AAC 55.171 by providing certainty that the interstate tariff rate will apply to all royalty and severance taxes paid to the State. The State is currently treating independent producers, such as Anadarko, differently when calculating royalty and severance taxes, which results in higher taxes for independent producers than affiliated producers.

Finally, properly applying the interstate rate for royalty and severance taxes under 15 AAC 55.171 will relieve the current burden the State has created for independent producers and in-state refiners. The State's misapplication of the calculation to determine the prevailing value of ANS has burdened in-state refiners with higher oil and gas prices than any out-of-state refiner pays, and there is no justification for that.

2. The State Recognizes that the Prevailing Value of Oil Is Based on the West Coast Market Price and a Netback Calculation Using the Interstate Tariff Rate.

As discussed above, the State's long-established practice consistent with sound economic principles requires that ANS crude oil be valued based on the West Coast market price. As discussed in more detail in Section 3 below, State law clearly identifies the West Coast as the starting point for determining the prevailing value of ANS oil for tax purposes.

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The State's oil and gas production taxes are addressed in AS 43.55.011(f) and consistently reference the West Coast as the marketplace for determining the value of ANS.[3]

Alaska regulations also recognize that for purposes of determining the prevailing value of ANS, the State must first look at the spot price for ANS in the marketplace. The provisions of 15 AAC 55.171(a)(1) define the "prevailing value for oil produced in the Alaska North Slope

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[3] AS 43.55.011(f) provides:

> (f) The levy of tax under this section for oil and gas produced north of 68 degrees North latitude, other than oil and gas production subject to (i) of this section and gas subject to (o) of this section, may not be less than
>
> (1) four percent of the gross value at the point of production when the average price per barrel for Alaska North Slope crude oil for sale on the *United States West Coast* during the calendar year for which the tax is due is more than \$25;
>
> (2) three percent of the gross value at the point of production when the average price per barrel for Alaska North Slope crude oil for sale on the *United States West Coast* during the calendar year for which the tax is due is over \$20 but not over \$25;
>
> (3) two percent of the gross value at the point of production when the average price per barrel for Alaska North Slope crude oil for sale on the *United States West Coast* during the calendar year for which the tax is due is over \$17.50 but not over \$20;
>
> (4) one percent of the gross value at the point of production when the average price per barrel for Alaska North Slope crude oil for sale on the *United States West Coast* during the calendar year for which the tax is due is over \$15 but not over \$17.50; or
>
> (5) zero percent of the gross value at the point of production when the average price per barrel for Alaska North Slope crude oil for sale on the *United States West Coast* during the calendar year for which the tax is due is \$15 or less.

Emphasis added.

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area ("ANS") and delivered to the United States West Coast, including Hawaii," as "the average spot price for ANS at the United States West Coast during the month that is referenced in the sales contract pricing provision."

In order to compute a West Coast ANS oil price, the State must deduct all costs of transporting the oil to the West Coast. This includes tanker costs as well as the TAPS interstate tariff rate, which is required to transport the oil from Pump Station 1 to the Valdez Marine Terminal. The Alaska Supreme Court has adopted this basic economic principle.

In 2013, the Alaska Supreme Court found that "[s]tandard pricing for Alaskan oil, whether title is transferred at Pump Station No. 1 or Valdez, is a netback to another market because there is no widely-traded market in [for ANS] Alaska."[4] The Court found that because the West Coast is the standard market to look to within the industry when determining the value of ANS, the only conclusion is that the interstate tariff would be used for the netback calculation.[5] The Court concluded that each party to the litigation was presumed to know that the standard method for pricing Alaska oil is a netback price that references the interstate tariff.[6]

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[4] *Tesoro Alaska Co. v. Union Oil Co. of California,* 305 P.3d 329, 335 (Alaska 2013).

[5] *Id.* Further, the Court also noted that "netback pricing is used in places like Alaska's North Slope where there is no widely-traded market for oil. It is a "'theoretical'" or surrogate price at Pump Station [No.] 1 net backed from a widely-traded market. A netback is the assumed final destination price less the assumed delivery charges to this hypothetical destination." (e.g., Los Angeles Basin [i.e., the West Coast]). (*Id.* at 332 n.3; *see also id.* at 334 n.14).

[6] *Tesoro,* at 335.

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The State has acknowledged this basic economic principle dating back to 1992 in its Royalty Settlement Agreements with North Slope producers. The State and BP Exploration (Alaska) Inc. (BPXA) entered into a Royalty Litigation Settlement Agreement that includes four market destinations for netback calculations: West Coast, Gulf Coast, Hess, and Mid-Continent.[7] The fact that the settlement does not include Valdez as a market destination for netback calculations shows that there is no market in Alaska in which to properly determine the value of ANS. Further, the BPXA Royalty Litigation Settlement Agreement states "[t]he volumes related to transactions in which title is transferred by BP to another party in Alaska shall be included in the West Coast destination category."[8] Each of these settlement agreements demonstrates the State's long-time understanding that the West Coast is the proper market to begin an assessment of the prevailing value of ANS.

The State's recognition of the West Coast as the proper market for determining the value of ANS can also be seen in many of the State's RIK contracts. In 2013, the State entered into

[7] 1992 BPXA Royalty Settlement Agreement Section 3.2(d); *see also* 1992 Exxon Settlement Agreement Section 3.2(d).

[8] 1992 BPXA Royalty Settlement Agreement Section 3.2(d)(i); *see also* 1992 Exxon Settlement Agreement at 3.2(d)(i).

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an amended RIK contract with Tesoro which acknowledges that the West Coast is the main marketplace where ANS is actively transported and sold and agreed that the West Coast market price would apply in the contract.[9]

Further, because the West Coast is the proper marketplace to value ANS, the proper tariff to use for netback purposes is the interstate tariff. The State specifically acknowledges this rationale in RIK contracts when providing that "[t]he Tariff Allowance provides an additional deduction from the ANS Spot Price equal to sum of the ownership-weighted average minimum interstate TAPS tariff filed with the Federal Energy Regulatory Commission."[10]

The State[11] used the same economic principle when negotiating a RIK contract with Flint Hills. The State's Best Interest Finding and Determination for the sale of ANS RIK oil

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[9] The State's best-interest finding with regard to that amended contract provides as follows:

> The pricing strategy in the proposed sale is meant to arrive at an equitable value for the state's royalty oil at the point where ownership is transferred to Tesoro. In order to determine the monetary consideration the State receives for its royalty oil, the proposed sale uses a netback valuation strategy. The netback value in the proposed sale is meant to represent the value of ANS sold on the United States West Coast (USWC) as it enters the Trans-Alaskan Pipeline System (TAPS) or the regulated pipelines upstream of TAPS Pump Station No. 1.

Alaska Department of Natural Resources, Final Best Interest Finding and Determination for the Sale of Alaska North Slope Oil to Tesoro Refining & Marketing Company, LLC (Oct. 2013), at III.A. That finding and determination also acknowledges that "the overwhelming majority" of ANS is sold on the United States West Coast and, therefore, to "account for the difference in value associated with transactions on the USWC versus Valdez, a location differential is subtracted (netted) out." *Id.*

[10] *Id.* at III.A.3.

[11] Alaska Department of Natural Resources.

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to Flint Hills Resources Alaska, LLC, states, "The ANS Spot Price represents the market value for North Slope oil sold on the U.S. West Coast. Judging by the prevalence of its use among many buyers and sellers of North Slope oil, the use of the ANS Spot Price as defined in the proposed RIK contract is a credible and reliable measure of the ANS market."[12] The State's Best Interest Finding and Determination for the sale of RIK oil to Flint Hills further acknowledges that "[t]he Alaska Department of Revenue has adopted a similar definition for use in its calculation of Prevailing Value for production tax purposes."[13]

Thus, historically, the State, through its statutes, regulations, and contracts recognizes the basic economic principle that the West Coast, as the dominant liquid point or marketplace in which ANS is actively traded, should be used for valuing ANS for royalty tax purposes.

3. Under Alaska Statutes and the Alaska Administrative Code, the Interstate Tariff Rate Is the Only Rate that Can Apply for Royalty and Severance Taxes.

In applying the Alaska statutes and regulations to determine the prevailing value of oil for royalty and severance tax purposes, the interstate rates are the only transportation rates that may be properly used in a netback calculation from the West Coast marketplace price. The West Coast is the only marketplace historically relied upon by the State when determining the value of ANS. The State has recognized this position for decades and relied upon interstate

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[12] *DNR Flint Hills Best Interest Finding and Determination for the Sale of Alaska North Slope Royalty Oil to Flint Hills Resources Alaska, LLC* (Feb. 2004) at III.A.1.

[13] *Id.*

rates for determining the value of ANS whether taken in-value or in-kind. In fact, the State's RIK contracts expressly incorporate interstate rates.

Prevailing value is a market concept, and Alaska law expressly bases the determination of prevailing value on the West Coast market. The provisions of 15 AAC 55.171, an implementing regulation for AS 43.55.020, defines "the prevailing value for oil produced in the [ANS] and delivered to the United States West Coast, including Hawaii," as based on the average spot price for ANS at the West Coast during the relevant month.[14] The regulation further defines "the prevailing value for ANS sold in the state at tidewater or delivered to coastal refineries in the state" as "the prevailing value determined in (a) of this section minus the volume-weighted average location differential between the Port of Valdez and the United States West Coast," meaning the marine transportation costs between the Valdez Marine Terminal and the market. The prevailing values for "ANS sold at Trans Alaska Pipeline System ("TAPS") pump station number one" and "ANS delivered to an inland refinery in the state," under subsections (g) and (h) of that section, respectively, continue the consistent netback logic of basing the prevailing value on the West Coast market by expressly referencing back to subsection (a), less the marine costs of subsection (f) and the lowest applicable publicly filed pipeline tariff.

Thus, 15 AAC 55.171 is completely consistent in tying the prevailing value of ANS to the nearest liquid point—the West Coast market—then adjusting for the point of sale. The final

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[14] 15 AAC 55.171(a).

destination or purchaser of the oil is irrelevant to the determination of the oil's prevailing value. With regard to the suggestion that (g) of that section requires use of the intrastate tariff if it is lower than the interstate tariff, that requirement applies to whatever *applicable* publicly filed pipeline tariffs a carrier may have, and no intrastate tariff is applicable when the market expressly used as the basis of the prevailing value determination is the U.S. West Coast. Subsection (g) applies to the narrow situation when a TAPS Carrier has two interstate tariff rates on file at the same time for the same interstate movement, such as when a Carrier maintains its generally applicable tariff but also provides a volume discount. Interstate commerce requires interstate rates. Until very recently, the State's longstanding interpretation has been in accordance with this plain analysis, and Anadarko respectfully requests that this interpretation be restored and that no regulatory changes be made.

4. The State Should Provide Independent Producers with a Consistently Applied Tax Policy.

All producers, independent and affiliated, are entitled to a consistent tax regime and should not be subject to changes in taxes based solely on the difference between state and federal tariff rates. Currently, the State gives preferential treatment to the TAPS Carriers and their production affiliates by providing assurances that interstate rates will be used for royalty and tax purposes, but, at the same time, the State denies that assurance to Anadarko and other independent producers. By denying those assurances to Anadarko, the State is requiring Anadarko to incur the risk and cost of litigation with the State over assurances the State is willing to give to the TAPS Carriers.

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As part of the recent global TAPS rate settlement,[15] the TAPS Carriers' affiliated producers received a guarantee from the State that the interstate rate would apply for the calculation of prevailing value of ANS for royalty and production taxes.[16] As an independent producer of ANS, Anadarko did not receive this treatment.

The unfairness of this position is demonstrated by the fact that it would result in different severance-tax rates for oil produced from the same well based on the identity of the producer. Under the State's current position on taxes, ConocoPhillips can rely upon interstate tariff rates and pay lower production taxes than Anadarko for oil produced from the same well merely because ConocoPhillips is an affiliate of one of the TAPS Carriers. Similarly, both Exxon and Anadarko sell oil to Andeavor for processing at its Nikiski refinery. Under the State's current tax position, Exxon can rely on the interstate rates and pay lower production taxes than Anadarko for oil sold within Alaska merely because Exxon is an affiliate of one of the TAPS Carriers.

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[15] The TAPS rate settlement has been approved by the Regulatory Commission of Alaska. (*Re ConocoPhillips Trans. Alaska, Inc.*, Order P–08–009(45)/P–08–013(42)/P–09–005(42)/-P–09–006(42)/P–09–010(31)/P–09–012(31)/P–09–015(31)/P–10–005(31)/P–10–010(23)/P–10–013(23)/P–11–006(21)/P–11–009(18)/P–11–011(7)/P–11–012(7)/P–11–022(7)/P–12–016(10)/P–12–017(10)/P–13–009(6)/P–13–010(6)/P–13–012(7)/P–14–023(6)/P–14–024(6) (Jan. 12, 2018)). The rate settlement is still pending before the Federal Energy Regulatory Commission.

[16] *2017 Settlement Agreement Regarding 2009-2015 Interstate Rates for the Trans Alaska Pipeline System*, §4. Use of FERC Tariff Settlement Rates for Purposes of State Royalty, Production Tax and Contracts for the Sale of Royalty Oil.

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All North Slope producers need to be able to rely on a consistent tax regime for royalty and severance taxes within Alaska. Independent producers particularly need these assurances in order to properly assess future oil exploration and investment opportunities within Alaska.

5. Alaskan Refiners Should Not Pay More for Alaskan Oil.

The State's current position on royalty and severance taxes burdens in-state refiners with increased costs of oil and gas and gives preferential treatment to out-of-state refiners. The State's refusal to afford assurances that the interstate transportation rate will apply to royalty and severance taxes has a punitive impact upon Anadarko and other independents as well as upon their Alaskan refinery customers.

When the State requires Anadarko and other independent producers to pay more in severance taxes for sales within Alaska compared with sales outside Alaska, the consequence will be to economically disadvantage sales from Anadarko and other independents to in-state refiners. Every North Slope producer should be required to pay the same taxes based on the prevailing value of ANS. However, the State's current application of 15 AAC 55.171 requires Alaskan independent producers, such as Anadarko, and in-state refiners, such as Andeavor, to pay more for Alaskan oil than any out-of-state refiner. There is no justification to disadvantage Alaskan refiners when purchasing ANS from Anadarko and other independents when compared with the TAPS Carriers' affiliate producers. The State's royalty and severance taxes should be fairly and equally applied to all producers, and nonaffiliated producers should not be economically disadvantaged by the State's royalty and severance tax policies.

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6. Conclusion.

For the reasons set forth above, Anadarko respectfully requests that the Department of Revenue consistently apply interstate tariffs to all North Slope producers when calculating the prevailing value of oil and gas under 15 AAC 55.171.

DATED this 26th day of January, 2018.

BRENA, BELL & CLARKSON, P.C.
Attorneys for Anadarko Petroleum Corporation

By ______________________________
Robin O. Brena, Bar No. 8410089
Kelly M. Moghadam, Bar No. 1105026

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CERTIFICATE OF SERVICE
I hereby certify that on January 26, 2018,
a true and correct copy of the foregoing
document was emailed to:

Mr. John Larsen
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Melody Nardin

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6. Conclusion.

For the reasons set forth above, Anadarko respectfully requests that the Department of Revenue consistently apply interstate tariffs to all North Slope producers when calculating the prevailing value of oil and gas under 15 AAC 55.171.

DATED this 26th day of January, 2018.

BRENA, BELL & CLARKSON, P.C.
Attorneys for Anadarko Petroleum Corporation

By ______________________

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CERTIFICATE OF SERVICE
I hereby certify that on January 26, 2018, a true and correct copy of the foregoing document was emailed to:

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